FASB Viewpoints

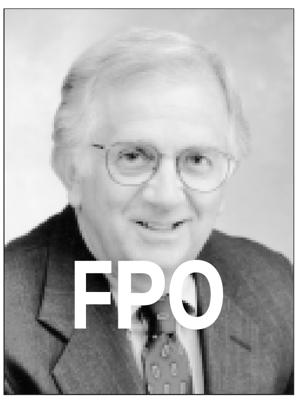
The Meaning of Neutral Financial Reporting

by James J. Leisenring, Vice Chairman, Financial Accounting Standards Board

"The purpose of accounting standards is to assure that financial information is presented in a way that enables decision makers to make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to a fair and accurate presentation, they fail in their purpose."

SEC Chairman Richard C. Breeden
Testimony to Senate Banking Committee
September 10, 1990

Persons who study the role of financial reporting in a free-market economy will find the words of Chairman Breeden to be obvious. To try and achieve any other purpose when establishing the standards by which companies report financial information would destroy the value of the reported information, contradict the purpose of financial reporting, and potentially undermine the capital markets.



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Fortunately our predecessors at the Financial Accounting Standards Board (FASB or Board) understood the role of financial reporting in our capital markets.[1] The Board's mission statement indicates: "Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information."

Fundamental to providing information useful to readers of financial reports is that the information be neutral. Neutral information reports economic activity as faithfully as possible, without coloring the image communicated in order to influence behavior in any particular direction. Neutral information is information free from bias towards a predetermined result.

Neutrality in accounting is an important criterion by which to judge financial reporting standards, for information that is not neutral does lose credibility and value. Presumably, we would all agree there would be little value to purposely altered information about inflation, census data, or unemployment. That information would no longer be useful for decision making. If information can be verified and can be relied on faithfully to represent what it purports to represent—and if there is no bias in the selection of what is reported—it cannot be slanted to favor one set of interests over another. Remember, there are two parties in any marketplace—buyer and seller. If accounting information favors one side, it must disfavor the other. Neutral financial information may in fact favor certain interests, but only because the verifiable information points that way, much as a good examination grade favors a good student who has honestly earned it.

That is not to say that reporting neutral information will not have consequences. Of course neutral information, if relevant and useful, has consequences. To the extent that financial reporting provides information that helps distinguish between efficient and inefficient uses of resources, or helps assess relative returns and risks of alternative investment opportunities, it will discriminate between entities. When that occurs, financial information is playing an important role in both pricing capital provided or even in denying capital to some entities or for some activities. Financial reporting will be properly doing its intended job by providing the information useful in making economic decisions that result in the efficient allocation of capital across entities and activities.

Unfortunately, it is once again fashionable to suggest that the FASB should abandon the notion that decision-useful information must be neutral and should consider the "economic consequences" of its decisions. Some would even assert that the FASB should try to determine in advance who will be relatively helped or hurt by the result of applying a particular accounting standard, and consider "public policy implications" when it establishes accounting standards. In a word, bias the informa-

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[1] *The points raised in this* Viewpoints *are for the most part included in FASB Concepts Statement No. 2,* Qualitative Characteristics of Accounting Information, *particularly in paragraphs 98–110.*

tion reported to influence the capital allocation or other economic decisions toward some predetermined objective, thereby undermining the proper functioning of the capital markets and impairing investors' and creditors' capital allocation decisions.

The FASB must resist any inclination to try and manage or otherwise influence the capital allocation process by distorting financial information. The Securities and Exchange Commission and Congress must do the same. One of the primary reasons the United States enjoys the most efficient capital market in the world is that investors and creditors can depend on receiving relevant and reliable financial information. It is essential to our market place that the providers of capital perceive that the information they receive is credible. Protecting the public confidence in financial reporting is the goal of the FASB and the only defensible public-policy objective to be pursued by anyone interested in preserving an effective and efficient capital allocation process in a market economy. The dissemination of biased and thus potentially misleading information is bad for all interests in market-driven economies. Even a perception that the information has been manipulated may have significant adverse consequences for the cost and availability of capital.

James J. Leisenring is Vice Chairman at the FASB. The views expressed in this article are those of Mr. Leisenring. Official positions of the FASB are determined only after extensive due process and deliberations.